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The Manufacturers Hanover
Economic Report

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Discount Deflation

The recent month-to-month declines in both the producer price index and the consumer price index have given rise to a belief in some quarters that the United States has not only brought inflation to heel—it has actually turned the corner and is now heading down the road toward deflation. As appealing as this may seem from a consumer's point of view (most people would rather pay lower prices than higher prices), generalized deflation could well pose serious problems for many sectors of the U.S. economy.

For sellers, of course, it means decreased revenues and lower profits for those whose prices are falling unless they are able to offset this with increased volume. Declining profits also mean lower tax revenues to the various taxing authorities with the result that they must curtail their services and cut payrolls. And of course, as many farmers and people in the oil business are discovering, lower prices mean that the value of the collateral that may be backing a bank loan has to be reduced, thereby requiring additional collateral which may not always be easy to come by.

If prices fall long enough, many businesses will cease investing because they will not be able to make a profit. Once that happens, joblessness goes up, consumer spending falls and the economy goes into a recession. Needless to say, while debtors have benefitted at the expense of creditors in periods of inflation, the reverse is true when inflation subsides and deflation sets in. The only problem is—the benefit to the creditors is small consolation if the debtors can't pay their debts.

Not to worry. We are a long way from generalized deflation. In fact, I would think that the price declines of the last couple of months are likely to be short-lived, and that rising prices will once more become the order of the day. Not that I am looking for an acceleration of inflation to, let's say, the double-digit range. Rather, I would only suggest that the underlying rate of inflation that has prevailed since the end of the last recession, around four percent, has not changed. This is due to the following four reasons: (1) virtually all of the declines in the producer and the consumer price index have been due to drops in prices of one commodity—oil; (2) most other items in the consumer price index continue to percolate upward in price; (3) the usual tendency for prices at this stage of the business cycle is for them to rise faster, not slower; (4) in this cycle in particular, there are several additional factors which argue for more, rather than less inflation in the months ahead.

Oil Pulls Down The Indexes...

Let's start out with one key observation. The consumer price index does not usually fall when the economy is expanding. Other than a decline in December 1982—one month following the officially-designated end of the last recession—the last time that the consumer price index posted a month-to-month decline when the economy was growing was back in August, 1965. The CPI rose even through the two freezes and four phases of the Nixon Administration's price controls of the early 1970s. Thus, for the consumer price index to fall as it did in February, and again in March, seasonally adjusted, at a time when the economy is generally agreed to be still in the expansion phase of the business cycle, something out of the ordinary has to be at work.

It is. Oil prices have plunged sharply since the end of last year, falling in spot markets by more than 60 percent. A decline of that magnitude in such an important commodity as oil was bound to show up in the price indexes in short order. However, it must be pointed out that petroleum prices represent only a small portion of consumer and producer prices. Furthermore, oil prices are not likely to stay down forever. Indeed, there are good reasons to believe that spot oil prices have already seen their lows. This is based on the combination of a pickup in demand from industrial users responding to oil's more competitive price compared with other sources of power, as well as from consumers, who are buying bigger cars and driving more, the sharp drawdown of inventories which should lead to

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pipeline refilling, as well as the possibility that some agreement to stabilize production might yet evolve. If and as oil prices do move higher, an important lid on inflation will be lifted.

Let us now turn to the rest of the price indexes. Excluding energy, producer prices in March rose at an annual rate of over six percent. Prices of such commodities as aluminum, copper, lumber and platinum are rising rapidly. As for consumer prices, there are many items whose prices in the year ending February were rising about as fast as they were in the previous couple of years—if not faster. For example, in the food category, foods purchased in restaurants are still rising at the same clip that they have been since 1983, while imported foods are going up at the fastest rate since 1980. Housing costs are rising more slowly than they did in 1985 or in 1984, but they are still rising at about the same pace that they did in 1983 and in 1982--the drop in fuel costs notwithstanding.

If you look at the service component of the consumer price index, you will see that it is still rising at above a five percent annual rate. Within that category, medical care services are rising even faster today than they were recently while most other services are rising close to their recent rates (See table).

...But Beneath The Surface...

Turning to the economy in cyclical perspective, Chart I shows you that the usual tendency for the rate of inflation in those business recoveries which lasted beyond three years is for it to accelerate. As you can see from the chart, the current recovery's price performance seems to be paralleling pretty closely the average trend of inflation during three comparable recoveries. Thus if the past alone is any guide, one might expect the rate of inflation to move somewhat higher later on this year, to perhaps a four percent clip.

Of course, there have to be good reasons for expecting a pickup in the rate of inflation—especially in the current context, when the latest readings show the

INFLATION RATES FOR SELECTED CONSUMER SERVICES

	12-Month Percent Change In:						
	Dec. 1980	Dec. 1981	Dec. 1982	Dec. 1983	Dec. 1984	Dec. 1985	Feb. 1986
Home Maintenance Services	10.7	10 5	4.5	7.9	3.3	2.9	4.1
Housekeeping	7.4	10 8	2.6	2.5	2.4	3.8	3.2
Dry Cleaning	12.8	10.8	6.0	5.2	5.2	4.5	4.3
Auto Maintenance	10.9	8.5	6.2	3.8	3.2	3.3	3.1
Medical Care Services	10.3	12.7	11.3	6.2	5.8	6.9	7.3
—Physicians' fees	11.0	11.7	7.5	7.5	6.0	6.9	6.8
—Dentists' fees	10.7	10.2	5.9	8.2	7.5	5.4	5.5
Entertainment Services	8.7	7.3	6.8	5.4	5.7	4.4	3.6
Personal Care Services	8.0	7.5	5.8	3.6	4.9	3.6	4.0
Educational Services	12.4	13.1	12.6	9.9	9.3	7.9	7.9

Source: Bureau of Labor Statistics

CHART I
12-MONTH PERCENT CHANGE IN CONSUMER PRICE INDEX
CURRENT RECOVERY (LINE), AVG. OF 3 COMPARABLE RECOVERIES (DOT)

Source: Bureau of Labor Statistics

major price indexes heading south. There are. I would say that the main reason why inflation begins to pick up at this stage of a business expansion stems from a fuller utilization of both labor and capacity. Chart II shows you that until recently there was a pretty good relationship between the employment rate (the percentage of the over-16 population at work) and the inflation rate. The rise in the value of the dollar between July 1980 and February 1985 caused this relationship to diverge and that divergence has been continued for now by the fall in oil prices. However, you should not overlook the fact that both employment and the employment rate are in near-record territory, suggesting that many labor markets may be tighter than they look.

This can be seen from a glance at wage settlements. In contrast to the situation that prevailed in early 1983, when virtually no first-year wage increase was negotiated in major collective bargaining settlements, first-year wage increases are now running better than two percent. As a result of this, along with a recent decline in labor productivity, unit labor costs have begun to rise, whereas back at the end of summer, 1983, the four-quarter percent change in unit labor costs was actually negative.

It is difficult to determine why productivity has slowed, thereby helping to push up unit labor costs. Some explanations might include under-investment, too much government regulation, a gradual shift in employment from manufacturing to services along with the difficulty of measuring output in these industries, and earlier efforts to cope with more expensive energy by substituting labor for machinery.

The same disparity may be noted when one compares the rate of capacity utilization in manufacturing with changes in prices, in this instance at the producer or the wholesale level. It is true that capacity utilization is still running close to 80 percent, quite low for the fourth year of a business recovery, and well below the high 80s/low 90s observed during this stage of several previ-

ous business expansions. However, it is also a fact that over the past 15 years, when capacity utilization was at today's rates, inflation was as high as eight percent.

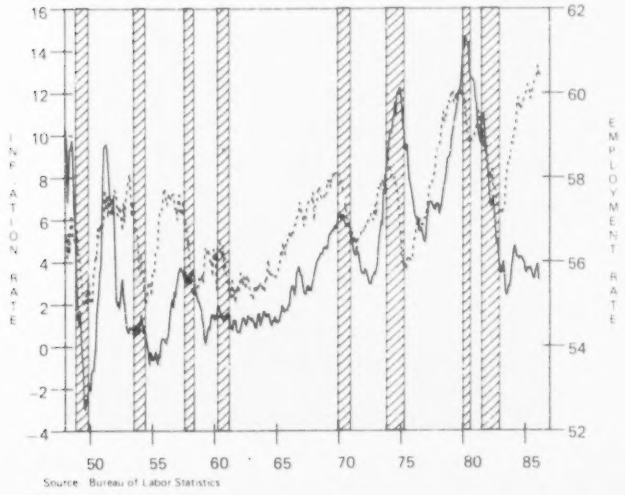
...Price Pressures Persist

Given the relatively low rate of capacity utilization and the fact that there is still over seven percent of the work force unemployed, it might be odd to talk about demand pressures reappearing, thereby driving prices up faster. However, looking at the employment rate, as well as the behavior of many components of the price indexes, we may not be all that far from this development. Certainly, the urge to raise prices has not disappeared with the low rate of inflation. If anything, it has become stronger than ever, since the inability to raise selling prices has cut into many companies' profits and margins.

One indication of how quickly prices are being raised once conditions permit comes from the automobile industry. A major domestic manufacturer recently announced an increase in prices of this year's models of about three percent. This follows a rise in prices of such foreign automobiles as those which come from Japan by close to 15 percent. The rise in prices of Japanese autos, as well as of other Japanese goods in particular and imports in general stems from the steep plunge in the value of the dollar against the yen and many other key currencies. This is already beginning to show up in the price statistics. Chart III shows you that import prices in general turned up toward the end of last year, and since they tend to influence prices of other commodities, it should not be too long before these prices begin to rise more rapidly as well.

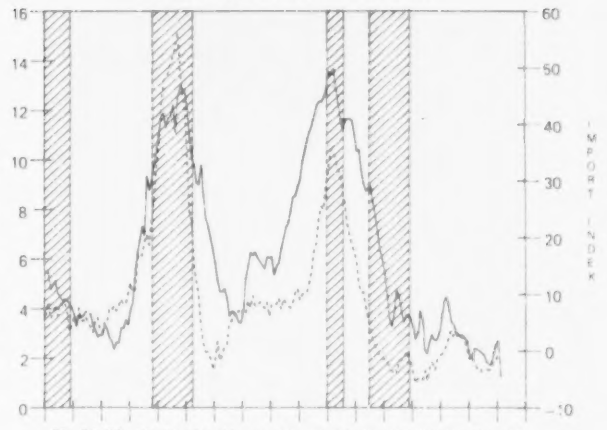
Certainly, one cannot be sanguine about inflation prospects from a look at either monetary or fiscal policy. Since the middle of 1982, the money supply has been growing at better than an 11 percent annual rate. This

CHART II
12-MONTH PERCENT CHANGE IN CPI (LINE)
VS. EMPLOYMENT RATE (DOT)



Source: Bureau of Labor Statistics

CHART III
12 MONTH PERCENT CHANGE IN CONSUMER PRICE INDEX OF COMMODITIES (LINE) AND IN UNIT VALUE INDEX OF IMPORTS (DOT)



Source: Bureau of Labor Statistics, Department of Commerce

has resulted in the creation of an enormous pool of liquidity in the U.S. and elsewhere, and has caused interest rates to decline as the supply of money has outpaced its demand. Those who place great emphasis on the money supply as a predictor of inflation have, of course, been wrong in recent years because of the influence of the earlier strength of the dollar, and more recently, of the decline in oil prices. However, the lower-valued dollar removes one lid on inflation, and if oil prices rise, the other lid will come off, leaving the economy exposed to the excess liquidity that this recent runup in the money supply represents, thus the potential for higher rates of inflation.

If the Federal Reserve had any thoughts of slowing the growth of the money supply to offset these inflationary tendencies, the trend of the government's budget deficit will make it think twice. In the past four years, the deficit has averaged five percent of the gross national product—more than twice as much as it did in the previous four years. Last year's budget deficit was a record-shattering $211.9 billion and this year's promises to be no smaller. This puts the Federal Reserve in a quandary when it comes to monetary policy. The lower-valued dollar by definition means less money is coming into this country available for investment in our financial markets. At the same time, prospects for faster economic growth suggest that the private sector will need to borrow more money this year than last year.

If the Fed wants to keep interest rates down to ensure that this growth will indeed occur, it will have to continue its policy of rapid money growth. With the dollar down, and oil prices likely to go no lower—if not rise—along with the other factors listed above, it is hard to escape the conclusion that we are not on the road to deflation but are traveling the same inflation path we have been on for the last few years. What is more, we had better be watchful that we don't switch to a road that brings even higher inflation in the near future. H

Better than ever in our 20th year.

The Manufacturers Hanover Westchester Classic will be held at the Westchester Country Club in Harrison, NY, June 2-8, 1986.

- Roger Maltbie, defending champion and other top pros from the PGA Tour, will compete for $600,000 in prize money, and the winner's purse of $108,000.
- Proceeds help support the following area hospitals: United, Lawrence Auxiliary, New Rochelle, Northern Westchester, Phelps Memorial, St. Agnes, St. John's, St. Joseph's, St. Vincent's, Blythedale Children's, Greenwich, Mount Vernon, White Plains, Yonkers General.
- Tickets on sale at all these hospitals through June 1st, thereafter at the gate. To charge with MasterCard or VISA, call 212-808-8519, Monday to Friday, 9am-5pm.
- For more information call (914) 967-5356.

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